



Derivatives Mishaps and What We Can Learn From Them

Chapter 34

Big Losses by Financial Institutions

- Allied Irish Bank (\$700 million)
- Amaranth (\$6 billion)
- Barings (\$1 billion)
- Daiwa (\$1 billion)
- Kidder Peabody (\$350 million)
- LTCM (\$4 billion)
- Midland Bank (\$500 million)
- National Westminster Bank (\$130 million)
- Societe Generale (\$7 billion)
- Subprime Mortgages (up to \$40 billion)

Big Losses by Non-Financial Corporations

- Allied Lyons (\$150 million)
- Gibsons Greetings (\$20 million)
- Hammersmith and Fulham (\$600 million)
- Metallgesellschaft (\$1.8 billion)
- Orange County (\$2 billion)
- Procter and Gamble (\$90 million)
- Shell (\$1 billion)
- Sumitomo (\$2 billion)

Lessons for All Users of Derivatives

- Risk must be quantified and risk limits defined
- Exceeding risk limits not acceptable even when profits result
- Do not assume that a trader with a good track record will always be right
- Be diversified
- Scenario analysis and stress testing is important

Lessons for Financial Institutions

- Do not give too much independence to star traders
- Separate the front middle and back office
- Models can be wrong
- Be conservative in recognizing inception profits
- Do not sell clients inappropriate products
- Liquidity risk is important
- There are dangers when many are following the same strategy
- Do not finance long-term assets with short-term liabilities
- Market transparency is important

Lessons for Non-Financial Corporations

- It is important to fully understand the products you trade
- Beware of hedgers becoming speculators
- It can be dangerous to make the Treasurer's department a profit center